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PUBLIC INTEREST COMMENT

COMMENT FOR THE COMPTROLLER OF THE CURRENCY'S PROPOSED RULE REGARDING PERMISSIBLE INTEREST ON LOANS THAT ARE SOLD, ASSIGNED, OR OTHERWISE TRANSFERRED

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Rule Regarding Permissible Interest on Loans that are Sold, Assigned, or Otherwise Transferred
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We appreciate the opportunity to submit a comment to the Office of the Comptroller of the Currency (OCC) in response to its proposed rulemaking clarifying the permissible interest on loans that are sold, assigned, or otherwise transferred by national banks and savings associations.[1] The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group. Rather, it is designed to help the OCC as it considers how to implement these policies. Specifically, the comment seeks to help the OCC provide clarity to banks and credit markets regarding the validity of legal loans that are sold or transferred to third parties after their creation.

The ability of a national bank or savings association to make a loan consistent with the relevant federal law and then sell that loan, with the loan remaining valid and functional on its original terms, is a critical aspect of the business of banking. Being able to sell loans is an important tool for risk management and profit maximization. Unfortunately, recent legal precedent has deviated from well-settled expectations and called this ability into question.[2] The OCC has the authority and opportunity to clarify that, under existing law, banks are allowed to make loans

1. Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 84 Fed. Reg. 64229 (proposed November 21, 2019) (to be codified at 12 C.F.R. pt. 7 and pt. 160).
2. Madden v. Midland Funding, LLC, 786 F.3d 246 (2nd Cir. 2015).

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unencumbered by the limits on interest imposed by borrowers' states' laws and then sell those loans, with the loans remaining valid and enforceable on their original terms, provided the sale does not impose any materially new or more onerous obligations on borrowers. The OCC has proposed making just such a clarification to the relevant regulations and should do so,[3] and the proposal should also make clear that assigning rights to a loan such as receivables also remains valid. As discussed further on, such a clarification is doctrinally sound, fair, economically sensible, and consumer protective.

THE PROPOSAL IS DOCTRINALLY SOUND

The OCC's proposal rests on several strands of well-settled doctrine. Therefore, the OCC should feel confident that it is acting in accordance with the law and Congress's intent as it clarifies that the mere transfer of a loan cannot invalidate it.

One of the arguments the OCC can rely on is the valid-when-made doctrine.[4] The valid-when-made doctrine establishes that a nonusurious loan that is valid at its inception does not suddenly become usurious and thus invalid when reassigned to a third party, even if the loan would have been usurious if originally made by the third party. The principle underlying the valid-when-made doctrine was articulated by the Supreme Court in *Nichols v. Fearson* in 1833.[5]

In *Nichols*, the court said that one of the "cardinal rules in the doctrine of usury" is that "a contract, which, in its inception, is unaffected by usury can never be invalidated by any subsequent usurious transaction."[6] It is important to note that the court did not see itself as forming a new principle to deal with issues arising from potentially usurious contacts, but instead as articulating a widely accepted, well-established maxim. Since the beginning of the 19th century, courts have held that borrowers should not be able to get out of their loans because of subsequent transactions that have no impact on the duties created by their original contract.[7]

While critics have pointed out that the circumstances that gave rise to these cases,[8] with one notable exception,[9] were different than those being discussed in the current controversy, it is not clear why those differences are meaningful or should change the overarching analysis. While the transactions were different in the 19th century, this should not be surprising—banking is a constantly evolving industry. However, what cases such as *Nichols* do share with the present is the question of whether events that take place after loans are created that have no material bearing on borrowers' obligations should serve to free borrowers from their obligation. Now, as then, the answer is no.

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3. 12 C.F.R. § 7.4001 (2019); 12 C.F.R. § 160.110 (2019).
4. Ironically, while the *Madden* decision has served as a catalyst for the current disruption in settled expectations, it did not deal with the valid-when-made doctrine at all; rather, it relied only on a questionable interpretation of the scope of National Bank Act preemption as it applied to a bank's ability to sell nonperforming loans. *See* Brief for the United States as Amicus Curiae at 19, Midland Funding, LLC v. Saliha Madden, No. 15-610 (U.S. May 24, 2016).
5. 32 U.S. 103 (1833).
6. *Id.* at 109.
7. Nichols v. Fearson, 32 U.S. 103 (1833); Gaither v. Farmers & Mechanics Bank, 26 U.S. 37 (1828); FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981); Strike v. Trans-West Discount Corp., 92 Cal. App. 3d 735 (Cal. Ct. App. 4th Dist. 1979); Tuttle v. Clark, 4 Conn. 153 (1822).
8. *See, e.g.*, Brief of Professor Adam J. Levitin as Amicus Curiae, Rent-Rite SuperKegs West, LTD. v. World Business Lenders, LLC, 603 B.R. 41 (Bankr. D. Colo. 2019) (No. 18-1099 TBM).
9. Strike v. Trans-West Discount Corp., 92 Cal. App. 3d 735 (Cal. Ct. App. 4th Dist. 1979).

Also, many of the attacks on valid-when-made are better understood as involving the question, Who is the true lender? When banks originate loans with the understanding that they will sell the loan or an economic interest in the loan to an outside party, there is a debate as to whether banks or outside parties should be considered the true lender for purposes of determining what law should apply. That debate is important, but it is different from the debate over valid-when-made because it involves the original validity of the loan, rather than whether the validity of a loan can change owing to subsequent transfer. As the OCC notes, the true-lender question is beyond the scope of this rulemaking.[10]

A second foundation for the proposal is the well-established rule that an inherent corollary of the ability to make a loan is the ability to sell that loan without significantly altering the terms of the original contract.[11] Contrary to the decision in *Madden v. Midland Funding, LLC,* as held by the US Court of Appeals for the Second Circuit, being unable to sell loans at one price to the whole market impairs banks' right to make loans, since selling a loan is a corollary to making it, and this reduces banks' ability to manage risk. This impairment of banks' federally granted power by state law runs contrary to Congress's intent and should be corrected.

Finally, as the OCC notes,[12] traditional contract principles support the proposal, since the buyer of the loan should be able to stand in the shoes of the originator of the loan with regard to the original obligations of the loan.

THE PROPOSAL IS FAIR

In addition to being doctrinally sound, clarifying that a loan does not become invalid simply because it is transferred to a different party is also fair. Put another way, it is unfair to allow a borrower to escape an otherwise valid contract simply because a subsequent event that does not materially change the borrower's obligations, such as a sale of the loan, occurs.

For the proposal to be relevant the loan must actually be valid when it is made. If a loan is for any reason illegal or invalid at the time of creation, valid-when-made does not apply. Therefore, in a case where the proposal is relevant, the borrower negotiates for a loan that complies with the relevant federal law. The characteristics of the loan, such as the interest rate, are set by the bank, consistent with its legal rights and obligations at the time the loan is consummated, and the borrower receives the benefits of the federal consumer protection regime that governs bank loans. A subsequent sale of the loan does not materially change the characteristics of the loan or the borrower's obligations. Instead, borrowers remain in the bargains they lawfully struck. As such,

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10. While appropriately outside the scope of this rulemaking, a separate but related issue of whether the bank or an outside entity is the "true lender" in circumstances where the bank originates loans with an understanding it will sell some or all of the loan or the loan receivables to the outside entity will also need to be addressed. There is a split in authority among the courts as to whether the contract between the borrower and lender should control or whether the courts should seek to divine the underlying economic substance of the transaction. The OCC should consider how it can clarify this question soon, since many of the policy issues raised by *Madden* are also affected by the true-lender question.
11. Planters' Bank of Miss. v. Sharp, 47 U.S. 301, 323 (1848) ("[I]n discounting notes and managing property in legitimate banking business, it must be able to assign or sell those notes when necessary and proper. . . ."); Sneeden v. Marion, 64 F.2d 721, 724 (7th Cir. 1933) (discussing a "bank's general powers to assign or mortgage negotiable instruments which it is authorized to take, whenever it is necessary and proper as an incident to the conduct of its business"); Rent-Rite SuperKegs West, LTD. v. World Business Lenders, LLC, 603 B.R. 41 (Bankr. D. Colo. 2019) ("[A]s a corollary and a matter of general contract law, state banks also have the power to assign promissory notes with such compliant interest rates to other entities, including national banks, other state banks, and non-banks such as the Lender. This has been an American rule for centuries.").
12. Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 84 Fed. Reg. 64229.

there is no justification to relieve borrowers of their obligation simply because a legally created loan is transferred.

THE PROPOSAL IS ECONOMICALLY SENSIBLE

Not only is valid-when-made a fair doctrine that respects the agency of the contracting individuals and holds borrowers to their agreed-upon obligations, it is also economically sensible. The ability of banks to sell loans and have those loans remain valid is critical to the modern economy. Not only does the ability to sell loans allow banks to manage risk and liquidity, it also allows banks to funnel additional money into the provision of credit beyond just banks' deposits, while shifting risk away from the taxpayer-backed safety net. For example, banks leveraged securities markets to fund over $226 billion in credit card loans between 2012 and 2018.[13] This represents 226 billion additional dollars competing for consumers' business, resulting in greater access and lower prices. It also represents $226 billion dollars of credit risk being moved away from depositors and federally guaranteed deposit insurance toward investors who understand and want the risk.

In the wake of the *Madden* decision the validity of this arrangement has been challenged.[14] The plaintiffs in the recent cases challenging credit card securitization use a logic that follows *Madden*; namely, that while the loan may have been valid when it was made by the bank, once the bank transferred the right to receivables from the loan to a special-purpose vehicle for the purposes of securitization, it supposedly lost its validity, even though the borrower's obligations have not changed.[15]

Failure to clarify that a loan remains valid even when it (or the right to its receivables) is sold will risk billions of dollars in credit and potential credit as investors refrain from investing owing to concern that the loans may become invalid. This effect will hit marginal borrowers (those who pose greater credit risks and therefore must be charged a higher interest rate) especially hard since those loans are the most likely to be implicated by state interest rate caps. As discussed later, there is evidence of this occurring in some contexts already, with unfortunate results.

Additionally, banks' ability not only to sell, but simply to know the value of their assets becomes much more difficult, and potentially even infeasible, when the value of the underlying assets can vary so greatly from buyer to buyer. If the validity of a loan depends upon the buyer's jurisdiction, a financial asset could be valued at over 50 different amounts depending on where the specific buyer is located within the United States. This creates a great deal of legal uncertainty as to enforceability and, thus, the value of contracts.

This uncertainty could make it virtually impossible for banks and other financial institutions to accurately assess the value of their underlying assets and report that value confidently on their balance sheets. In turn, it would be harder for potential investors to accurately gauge the financial state of the various firms in which they are considering investing. Uncertainty could have significant regulatory implications as well, as banks' capital and liquidity requirements are affected by the value

13. Brian Riley, Mercator Advisory Group, Asset-Backed Securities: A Primer for Credit Card Managers 9 (2019).
14. *See, e.g.*, Cohen v. Capital One Funding, LLC, EDNY 1:19-cv-03479-KAM-RLM; David Petersen v. Chase Card Funding, LLC, WDNY 1:19-cv-00741-LJV.
15. The sale of receivables in this case is economically equivalent to the sale of the loan.

of the assets they hold. Without an accurate assessment of their assets' worth, banks and other financial institutions cannot know the amount of liquidity and capital they are required to hold.

Clarifying that the mere sale or transfer of a validly made loan or the receivables from that loan does not change the applicable laws governing interest is an important step to restoring certainty to credit markets. This clarity will help ensure that potential borrowers get the full benefits of maximally competitive and liquid credit markets and will allow banks to confidently manage their risk and serve as the intermediaries for credit they are intended to be.

THE PROPOSAL IS CONSUMER PROTECTIVE

One of the main criticisms leveled against the valid-when-made doctrine by those who are skeptical of its desirability is that it could be harmful for consumers.[16] However, empirical evidence points to the opposite conclusion: the aftermath of *Madden* and the unsettling of long-standing expectations has actually harmed consumers.

Professors Colleen Honigsberg, Robert Jackson, and Richard Squire used the *Madden* decision as a natural experiment to assess the impact that an unexpected change of legal enforceability has on lending contracts.[17] Using data from three marketplace lenders who partner with banks (and who therefore were sensitive to the change in law wrought by the *Madden* case) the authors found that "not only did lenders make smaller loans in [Connecticut and New York] post-*Madden*, but they also declined to issue loans to the higher-risk borrowers most likely to borrow above usury rates."[18] Within the Second Circuit, fewer loans were originated for borrowers with FICO scores below 700 compared to comparable borrowers outside of the Second Circuit, with the effects most pronounced among riskier borrowers—individuals with FICO scores below 625—for whom originations decreased by 52 percent after *Madden*, while loans made to comparable borrowers outside the Second Circuit increased by 124 percent.[19] At the same time, the average loan size within these states fell, with the greatest impact falling on high-risk borrowers. This shows that, after *Madden*, riskier borrowers received fewer loans than they likely would have, and the loans they did receive were smaller in size. Reducing both the number and size of options that consumers have has the undesirable effect of excluding from the market a segment of borrowers who happen to be the most economically vulnerable.

Worse, there is emerging evidence that this reduction in credit access has led to an increase in bankruptcies. Professors Piotr Danisewicz and Ilaf Elard find an approximately 8 percent increase in personal bankruptcies in New York and Connecticut attributable to a lack of marketplace lending, which relies on a partnership between a bank and a nonbank that has been negatively affected by the *Madden* decision.[20] They also find a reduction in access to credit from marketplace lenders for the purpose of debt refinancing and medical expenses, two types of expenses that are strongly linked to bankruptcy risk.[21]

16. *See, e.g.*, David Dayen, *Trump's Bank Regulators Open the Door to More Predatory Lending*, THE AMERICAN PROSPECT, Nov. 19, 2019, https://prospect.org/power/trump%E2%80%99s-bank-regulators-open-the-door-to-more-predatory-lend/.
17. Colleen Honigsberg, Robert J. Jackson Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, 60 J.L. & ECON. 673 (2017).
18. *Id.* at 675.
19. *Id.* at 697–698.
20 Piotr Danisewicz & Ilaf Elard, The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy 3–4 (July 5, 2018) (available at https://ssrn.com/abstract=3208908).
21. *Id.*

These results, while distressing, are not surprising. If potential lenders cannot be certain that they will be paid back because the validity of their loan may suddenly and arbitrarily change based not on its initial validity but on whether it changes hands after it is created, they will refuse to risk their capital. Diminishing access to credit does not diminish the need for credit, especially in the case of emergencies. Further, the *Madden* decision results in the absurd outcome that a borrower can obtain a high-interest loan from a bank so long as the bank holds the loan, but effectively cannot access a low-interest loan from a different bank if that bank expects to sell the loan. This is not consumer protection; this is consumer harm. The OCC should clarify that the validity of a loan is not dependent on whether the loan is sold, which will help restore broader access to better credit for more borrowers.

CONCLUSION

The OCC's proposal is doctrinally sound, fair, economically sensible, and consumer protective, and the OCC should finalize it with the addition that it should make clear that assigned interests in loans such as receivables also remain valid. In doing so, the OCC can help restore clarity and certainty to the credit markets, vindicate banks' congressionally granted powers, and improve access to credit.